Internal Revenue Service

memorandum

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date: December 18, 1991

to: Abraham Romero, Revenue Agent
Exam Group 1112

from: Senior Technical Reviewer, Branch 1
Office of Associate Chief Counsel (International)

subject: [redacted]

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This is in response to your request for advice with regard to whether the foreign subsidiaries of [redacted], are required to pay U.S. income tax under section 882. We conclude that these corporations do not have "taxable income which is effectively connected with the conduct of a trade or business within the United States," and, thus, that they do not owe U.S. income tax.

Facts

[redacted], is a U.S. manufacturer and distributor of a variety of [redacted]. The corporation also purchases [redacted] from its wholly-owned subsidiaries in Spain and Puerto Rico for distribution in the United States. Each of the subsidiaries purchases [redacted] locally, and then processes and [redacted] in its own factories. Each subsidiary sells the products exclusively to its U.S. parent. Neither subsidiary undertakes any marketing activity in the U.S. and neither maintains a U.S. office or conducts business through a U.S. agent. Title to the [redacted] is transferred overseas.

An opinion was requested on whether U.S. income tax must be paid by the foreign corporations doing business in Puerto Rico and Spain.

Discussion

Section 882(a)(1) of the Code provides that "a foreign corporation engaged in a trade or business within the United States during the taxable year shall be taxable . . . on its taxable income which is effectively connected with the conduct of a trade or business within the United States." Section 882(a)(2) states that in determining taxable income for this purpose, gross income only includes gross income which is effectively connected with the conduct of a trade or business within the United States. Effectively connected income is defined by section 864(c)(1). That section notes (with exceptions not relevant here) that "in the case of a nonresident alien individual or a foreign corporation not engaged in trade or business within the United States during the taxable year, no income, gain or loss shall be treated as effectively connected with the conduct of a trade or business within the United States." Thus, in order to determine whether or not [redacted]'s subsidiaries need to pay U.S. income tax, the Service must determine whether each subsidiary is engaged in a U.S. trade or business.

The Code does not define when a foreign corporation that is selling inventory property is "engaged in a U.S. trade or business" for purposes of section 882. However, the regulations and case law help in determining the meaning of the phrase. For instance, Treas. Reg. § 1.864-2 states that trading in stocks or securities (for one's own account), or commodities, does not constitute engaging in a U.S. trade or business. On the other hand, a person will be considered to have a U.S. trade or business if that person has what amounts to a "permanent establishment" under a tax treaty.[1]

While the standard for engaging in a U.S. trade or business is lower than the standard for having a permanent establishment in the U.S., the facts indicate that the [redacted] subsidiaries had neither a U.S. trade or business nor a permanent establishment. Their activities in the United States were minimal: the subsidiaries did not have U.S. offices and they did not have U.S. agents to sell their products. The parent company negotiated the sales and took title to the products overseas. Case law indicates that selling inventory property to a U.S. distributor, without any other U.S. activity, is generally not sufficient to be

[1]Handfield v. Commissioner, 23 T.C. 633 (1955)(a person selling postcards on consignment to a U.S. distributor has a permanent establishment, and, therefore, a trade or business, in the United States).

considered engaging in a U.S. trade or business.[2]

Moreover, from January, 1991, the U.S.-Spain treaty[3] determines the treatment of U.S. source business profits received by a resident of Spain. Article 7, para. 1, of the treaty provides:

> The business profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on or has carried on business in the other Contracting State through a permanent establishment situated therein.

A "permanent establishment" is defined in article 5 as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." As noted above, the facts indicate that [redacted]'s Spanish subsidiary does not have a U.S. permanent establishment.

Conclusion

[redacted]'s foreign subsidiaries have no U.S. activities apart from selling their products to their U.S. parent for distribution. Therefore, section 882 and the U.S.-Spain income tax treaty provide that the subsidiaries' income is not effectively connected with the conduct of a U.S. trade or business, and thus, that it is not taxable in the United States.

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[2]See, e.g., Linen Thread Co. v. Commissioner, 14 T.C. 725 (1950).

[3]Convention Between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income, February 22, 1990.